



SpectremGroup

# The Use of Exchange Traded Funds vs. Mutual Funds

*A Spectrem Perspective, 2008*





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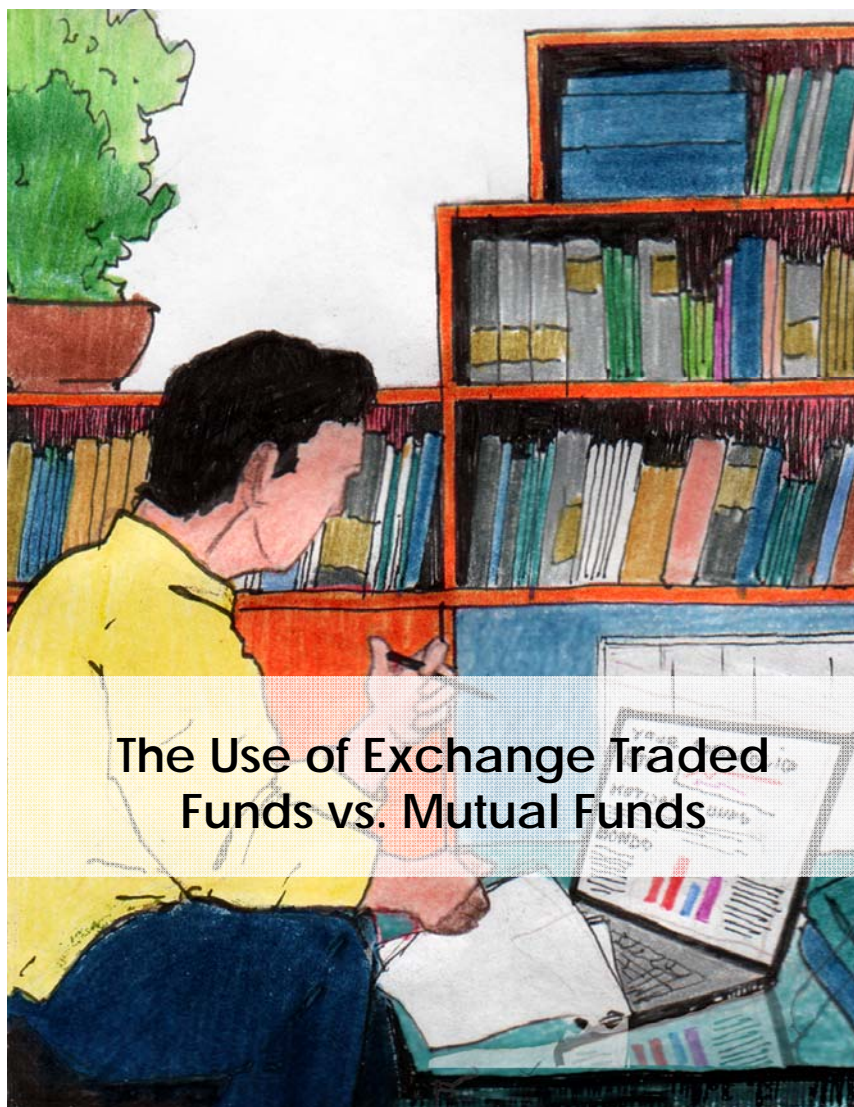
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**The Use of Exchange Traded  
Funds vs. Mutual Funds**

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# The Use of Exchange Traded Funds vs. Mutual Funds

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## Introduction

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The origin of Mutual Funds is uncertain, with some tracing the history to Adriaan van Ketwich, a Dutch merchant who in 1774, created funds which pooled investments together to minimize risk, thus making the investments available to poor and middle class investors. The first modern mutual fund in the United States was created in 1924 in Boston, Massachusetts and was known as Massachusetts Investors Trust, which ultimately led to the founding of the MFS Investment Management firm. Driven by the growth in the Defined Contribution Industry, Mutual Funds increased rapidly in popularity during the 1980's and 1990's with more investments spurred on by high returns.

Exchange Traded Funds (ETF's) have a much shorter life, with the Standard & Poor's Depository Receipts first introduced in January, 1993. However, Mutual Funds - with an 80 year history in the United States – face the possibility of an erosion of market share due to Exchange Traded Funds.

With the rapid rise in Exchange Traded Funds, and with their ease of trading, relatively low cost and tax advantages, some may find them more attractive than Mutual Funds. Will ETF's surpass Mutual Funds in their appeal to investors? What percentage of Affluent Investors have ETF's? Why don't more people invest in them? What are the principal barriers to investing in ETF's? Do investors plan to move more towards this product?

In this report, we answer these questions and analyze the perceptions, attitudes and behaviors of affluent investors towards Exchange Traded Funds and Mutual Funds.

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## Methodology

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This report was fielded by telephone in August and September of 2008. Five hundred respondents with over \$500,000 of investable assets responded to the survey.

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## Key Findings

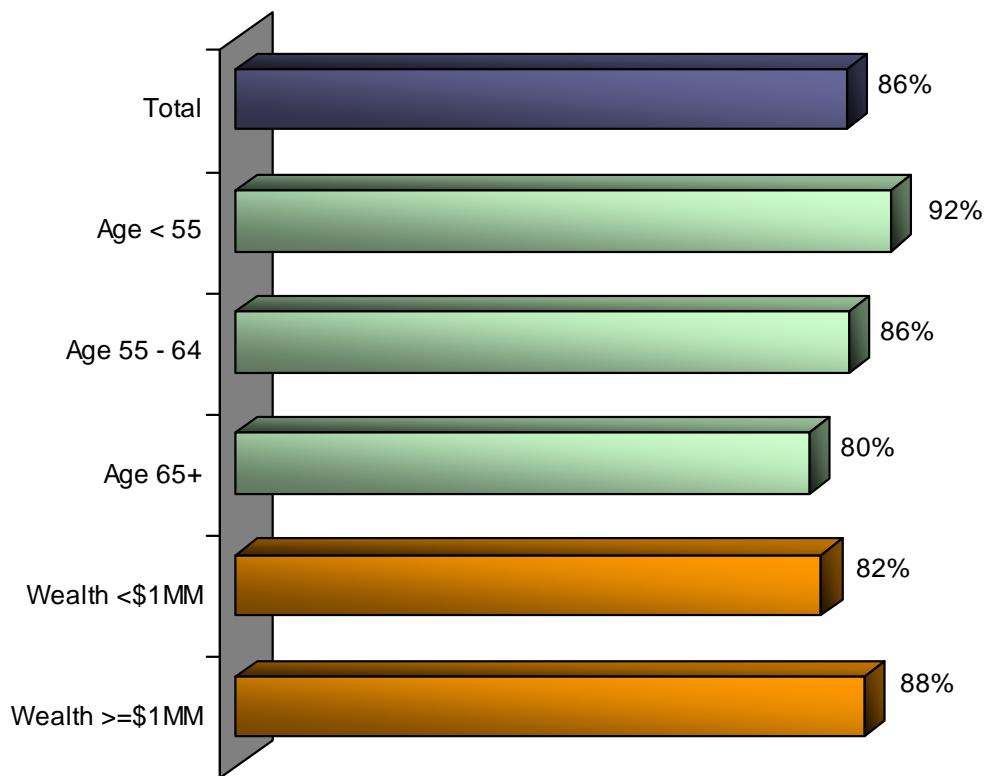
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- Mutual Funds have much greater ownership and awareness among the Affluent Investor than do ETF's. Nearly 90% of Affluent Investors own Mutual Funds, while only 16% have Exchange Traded Funds. This ownership trend and overall lack of awareness about Exchange Traded Funds, plus the lack of interest among advisors, strongly suggests that Exchange Traded Funds will not replace Mutual Funds as the product of choice in the near future.
- As an example, the lack of investment may be a function of the lack of knowledge about EFT's. Certificates of Deposits (CD's) are understood by over three quarters of investors while EFT's are understood by only 17%.
- Only 15% of the affluent indicate their advisor has ever talked to them about Exchange Traded Funds, suggesting either a lack of knowledge or interest among advisors in pushing this product. However, among those with ETF's, nearly half said they invested in them because of the recommendations of their financial advisor.
- Mutual Funds appear to have a strong hold on Affluent Investors. Only 12% indicate there are definite advantages in Exchange Traded Funds compared to Mutual Funds while other 12% indicate they will invest more in ETF's at the expense of Mutual Funds.
- Most of those who have ETF's took the funds for investment from cash accounts. Only 15% took the funds from existing Mutual Funds.

## Investment in Mutual Funds

Nearly 90% of affluent investors own Mutual Funds. Few products have the appeal, as evidenced by ownership rates, that Mutual Funds have. Those who are under age 55 show even higher percentages, and those who are wealthier show higher percentages as well. While Mutual Funds are heavily used...

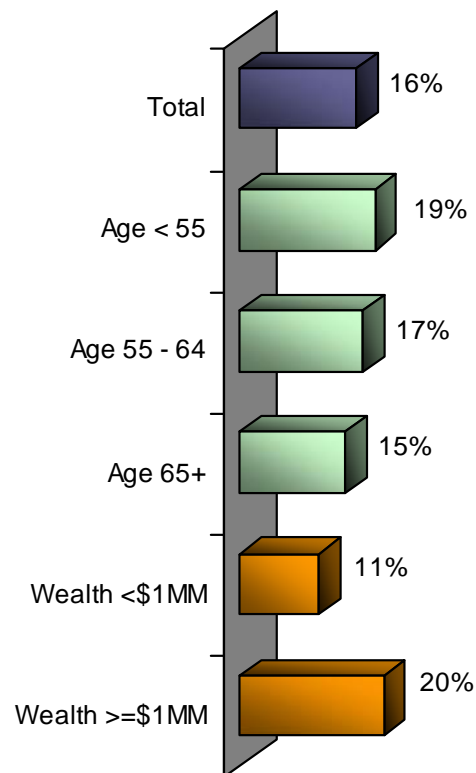
**Investment in Mutual Funds**



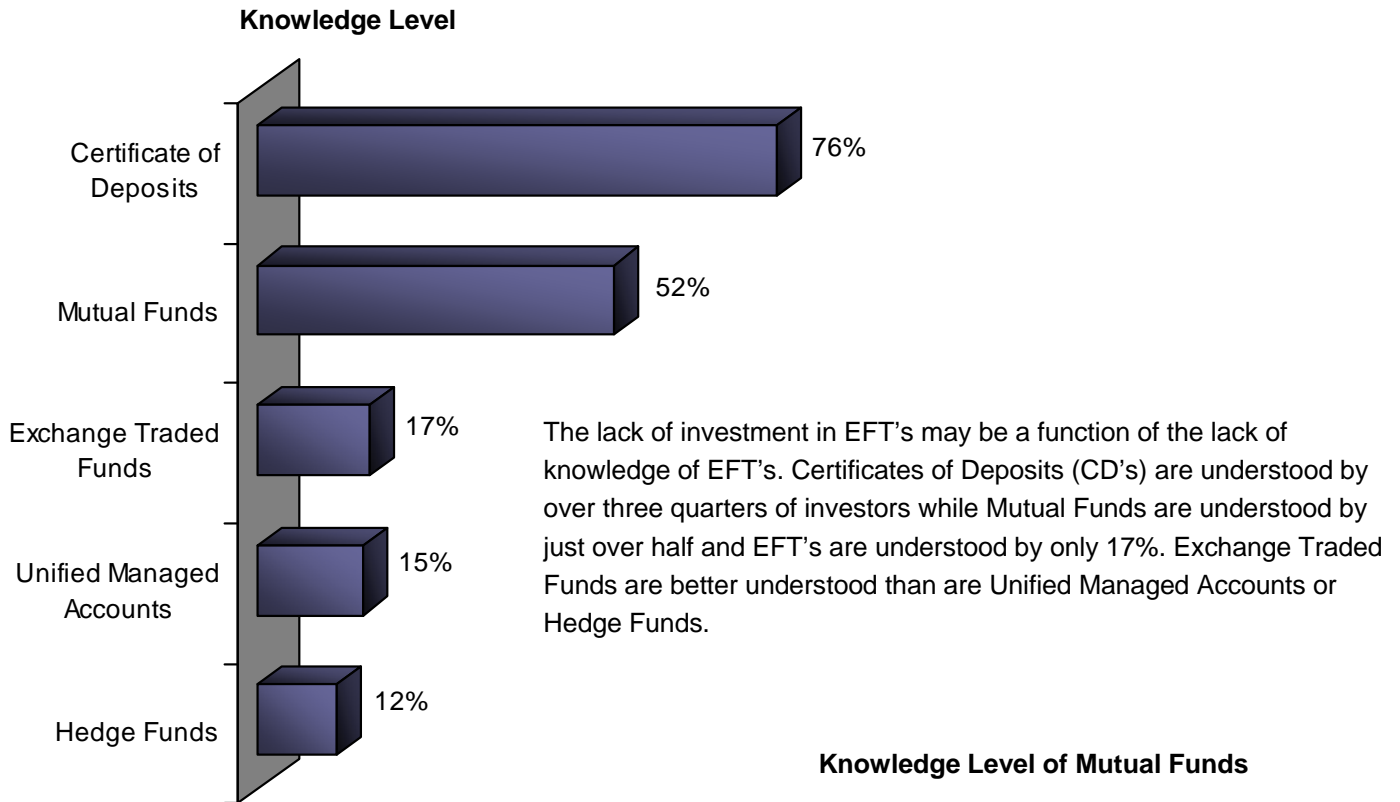
## Investment in Exchange Traded Funds

...use of Exchange Traded Funds is very sparse. Those who are under age 55 show more usage of ETF's as do those who are wealthier. The usage among the more wealthy may be due to a number of factors, including tax efficiencies and ease of trading. However, as with most investment products, usage is higher among the wealthy because they have more assets to spread around and consequently, they look for greater diversity in the type of investments they make.

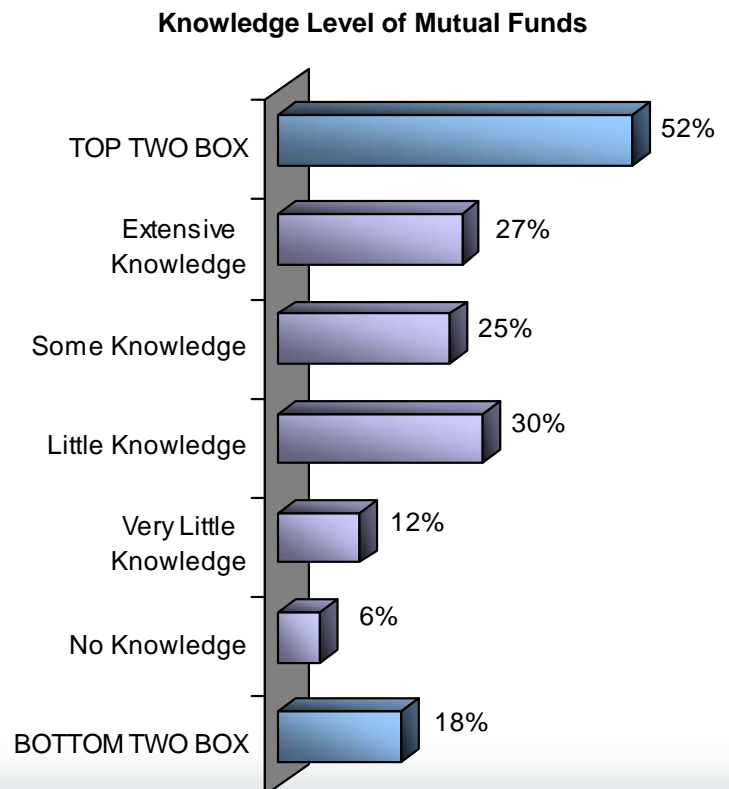
**Investments in Exchange Traded Funds**



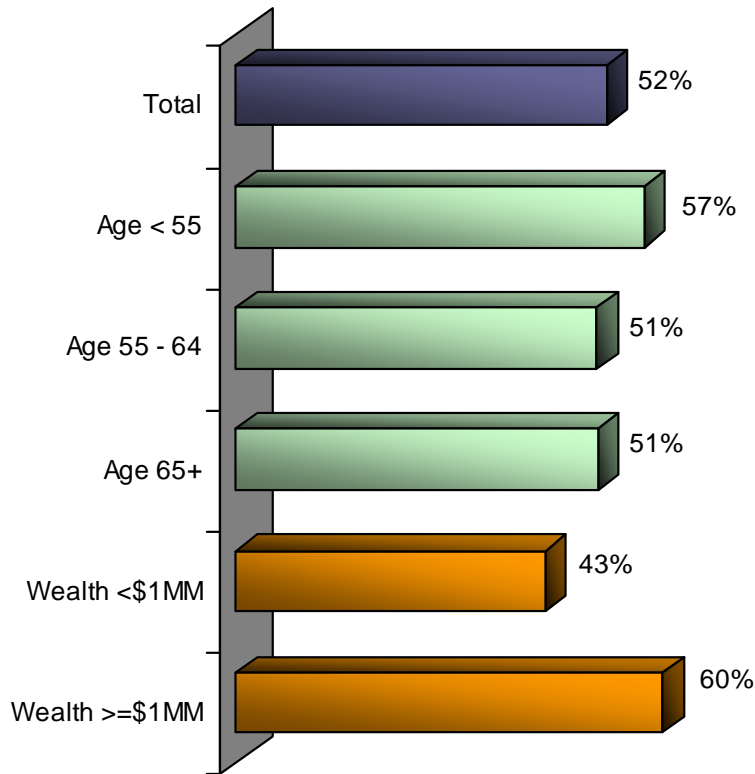
## Knowledge Level



Breaking these numbers down, we find that of the 52% with a knowledge of mutual funds, just over half of this group have extensive knowledge and while just under half have some knowledge. Overall, just under a third say they have little knowledge, 12% have very little knowledge and 6% have no knowledge.



## Knowledge Level

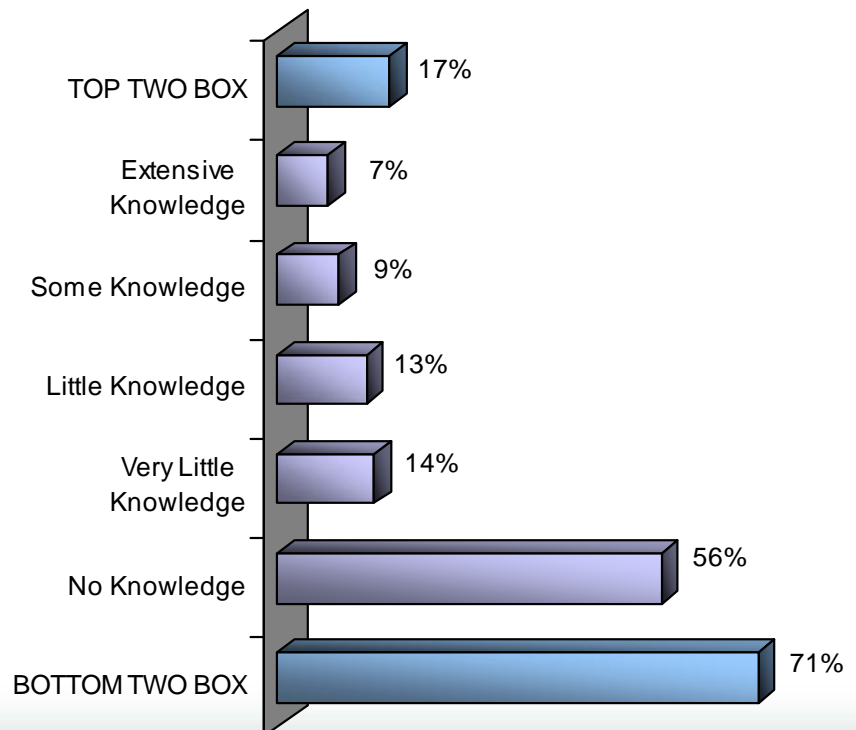


### Knowledge Level of Mutual Funds by Demographics

Those in the youngest age segment and those with over \$1 million of wealth have higher knowledge levels regarding mutual funds. The advent of new and increased communication tools such as the internet, printed publications about the financial world and cable and syndicated television programming geared towards investors, have created a more knowledgeable clientele. Younger investors tend to be more attuned to these new mediums of communication, and hence the greater level of knowledge.

### Knowledge Level of Exchange Traded Funds

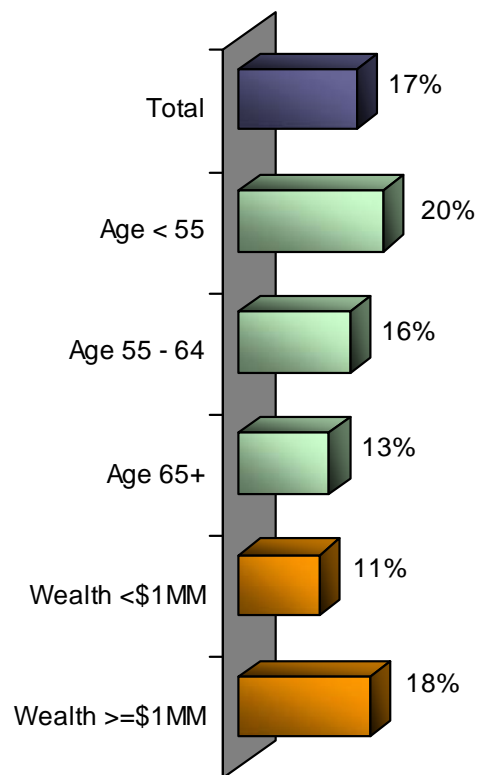
A breakdown of Exchange Traded Funds reveals a very low level of knowledge. Nearly three quarters indicate they have little or no knowledge of ETF's, with over half having no knowledge. Less than 20% indicate at least some knowledge and only 7% say they have extensive knowledge. Education becomes paramount in increasing usage of Exchange Traded Funds. This can come through public relations efforts, newsletters, seminars, brochures and other printed materials and by educating financial advisors about Exchange Traded Funds.



## Knowledge Level

Those who are under age 55 show a greater level of understanding and those with more wealth also exhibit a greater understanding of EFT's. Younger investors, with more investing years ahead of them, along with the capacity to accumulate greater wealth in their lifetimes, create a better scenario for EFT's than if the knowledge level was skewed towards the older generation.

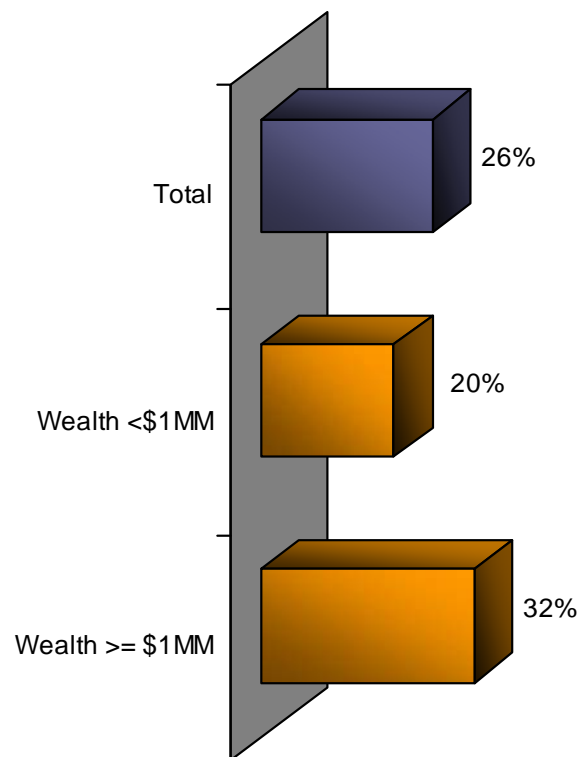
**Knowledge Level of Exchange Traded Funds**



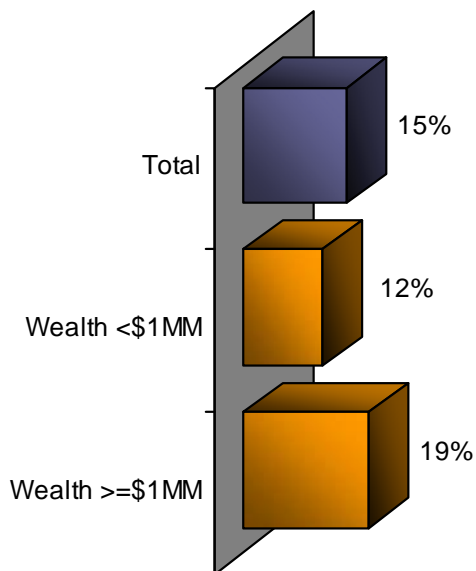
## Exchange Traded Funds - Knowledge Level Over the Past Year

Despite the low level of understanding of ETF's, a quarter of the Affluent indicate they have heard more about them in the past year than they have in the past. The increased buzz in financial publications and via the Internet has increased the general awareness of this product. However, relying only on public forums to highlight ETF's is not a good strategy. Financial service companies must educate perspective clients through their own advertising mechanisms and through careful training and working with their own advisors.

### Over The Past Year I Have Heard More About Exchange Traded Funds Than I Have In The Past



## Education by Financial Advisor Regarding Exchange Traded Funds



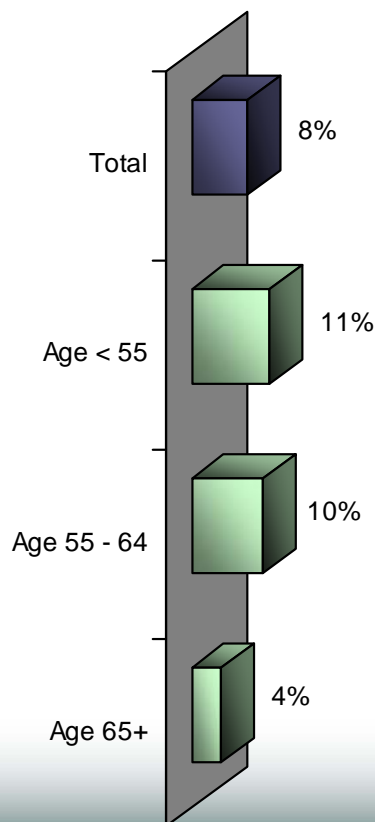
### My Financial Advisor Has Talked to Me About Exchange Traded Funds

Part of this lack of knowledge may be due to the lack of advisor education to Affluent investors regarding ETF's. Only 15% of the Affluent indicate their advisor talked to them about Exchange Traded Funds. Even among the more wealthy segment, only 19% acknowledge discussions with their advisor. With advisors being such a critical source of information to Affluent clients, having advisors on board as to the advantages and attractive features of Exchange Traded Funds is very important.

## Encouragement to Invest in Exchange Traded Funds by Financial Advisors

### My Financial Advisor Has Encouraged Me To Invest In Exchange Traded Funds

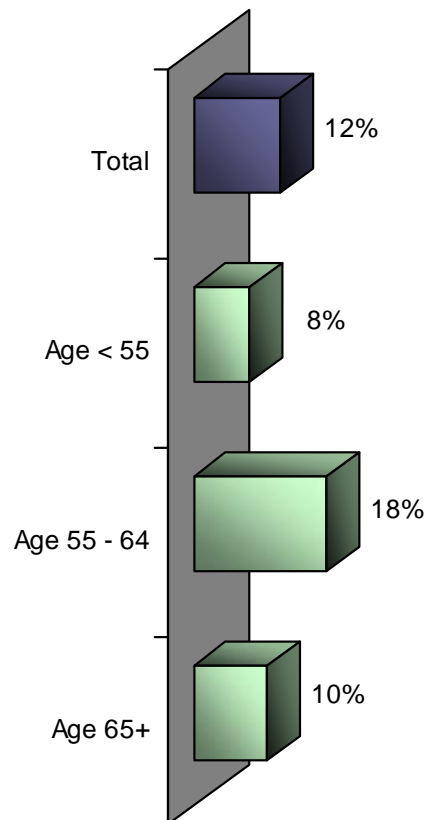
While 15% of the Affluent have heard about ETF's from their advisor, only 8% have had their financial advisor encourage them to invest in mutual funds. Among the oldest group, this percentage drops to 4%. This lack of encouragement from advisors could be a lack of understanding and knowledge on their part as well as a absence of incentive for pushing this product type. Both conditions must be addressed in order to expand the base of Exchange Traded Funds.



## Advantages of Exchange Traded Funds Compared to Mutual Funds

Only 12% indicate there are definite advantages in Exchange Traded Funds compared to mutual fund. No distinct patterns emerge when this question is viewed by various age groups. Clearly, investors are either not being told about the advantages of Exchange Traded Funds or they fail to understand what those advantages are.

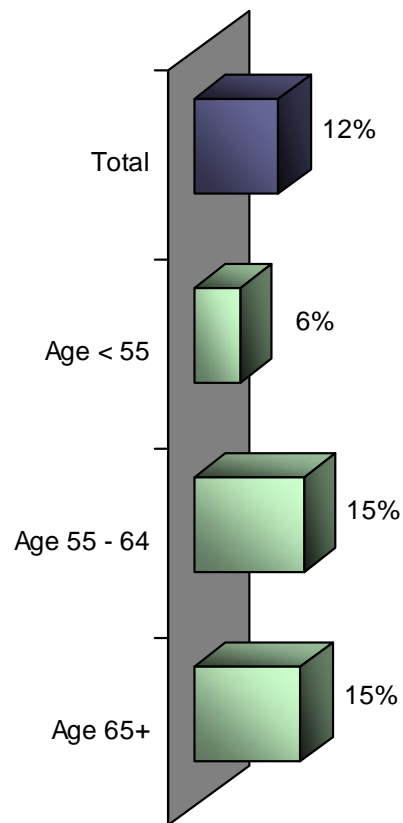
### I See Definite Advantages in Exchange Traded Funds Compared to Mutual Funds



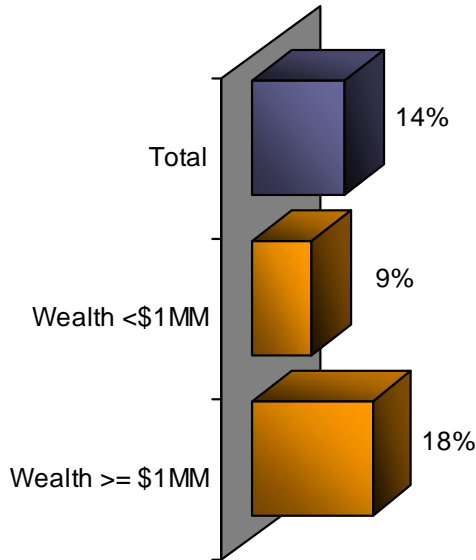
## Investment Trends – Exchange Traded Funds Versus Mutual Funds

Only 12% indicate they will invest more in ETF's at the expense of Mutual Funds. Interestingly, despite the greater level of knowledge among the younger group, they show a greater reluctance to move into ETF's from Mutual Funds.

### In the Future, I Will Invest More in Exchange Traded Funds and Less in Mutual Funds



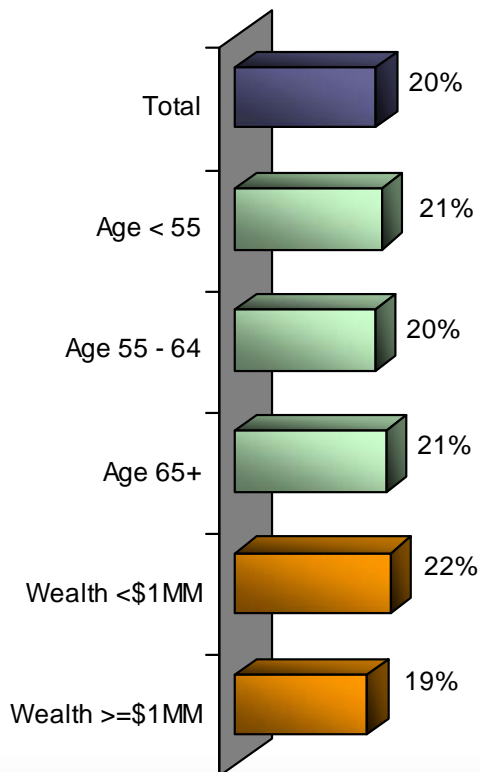
## Future of Exchange Traded Funds



### I Believe That In The Future That Exchange Traded Funds Will Become More Popular than Mutual Funds

Only 14% believe ETF's will become more popular than Mutual Funds. However, those with more than \$1 million see ETF's becoming more popular at double the rate of those with less than \$1MM. It does not appear ETF's will become more popular at the expense of Mutual Funds.

## Interest in Exchange Traded Funds

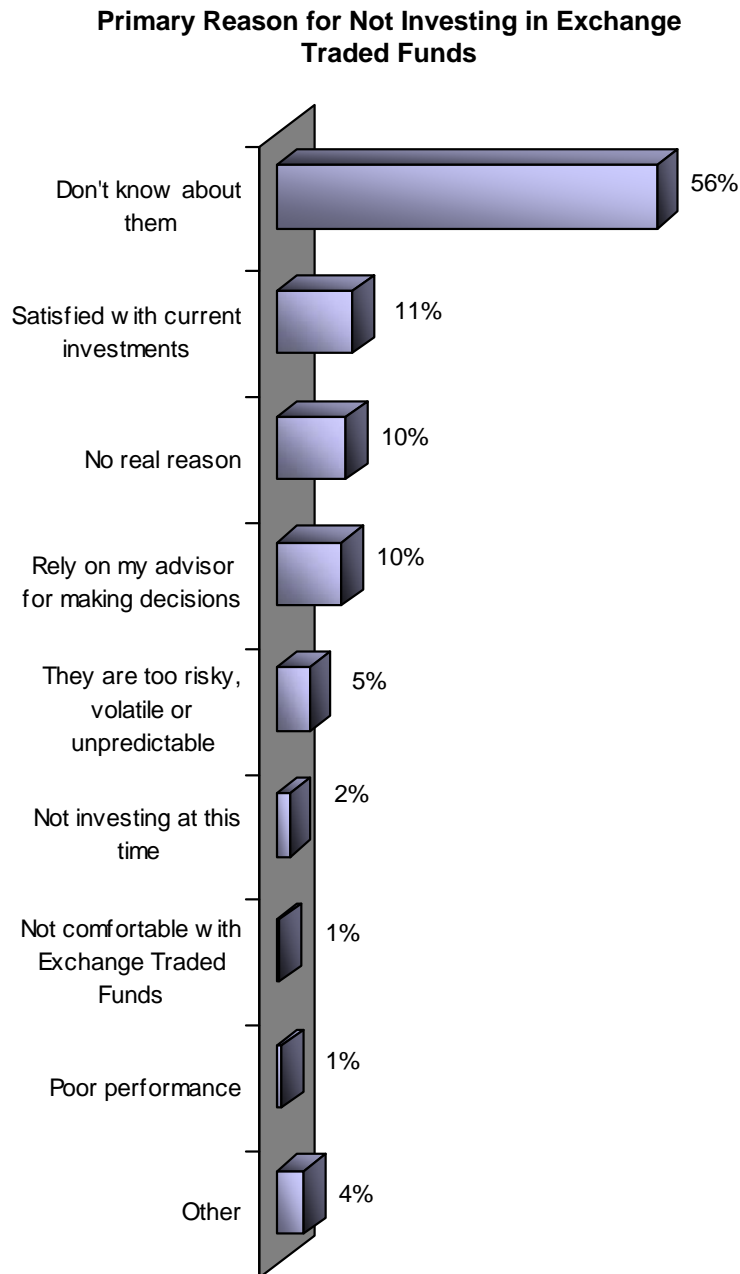


### I Would Be Interested In Finding Out More About Exchange Traded Funds

Despite the lack of encouragement or education from advisors, one-fifth of the Affluent indicate they would be interested in finding out more about Exchange Traded Funds. Age shows little difference in interest, and those with less wealth show slightly more interest than those with more wealth.

## Primary Reason for Not Investing in Exchange Traded Funds

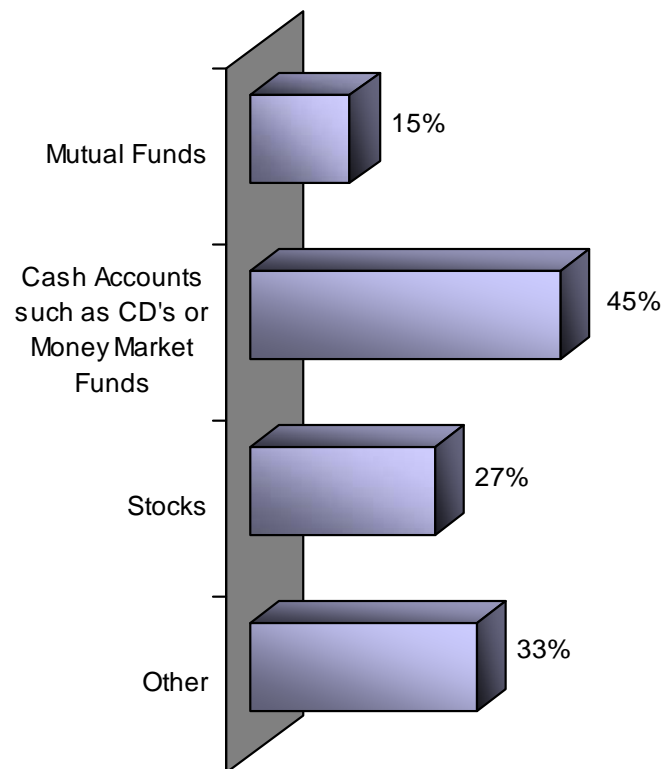
Overwhelmingly, affluent investors who don't have ETF's indicate the primary reason is a lack of knowledge about them. Satisfaction with current investments is the next reason, but is far below the lack of knowledge. "No particular reason" and a reliance on advisors are the next most important reasons for not investing.



## Source of Funds For Exchange Traded Funds

Most of those who have ETF's took the funds for investments from cash accounts. Only 15% took the funds from existing Mutual Funds, the lowest of any source. Stocks and other types of accounts were used more often than Mutual Funds as a source of capital for the opening of an ETF. This strongly suggests that Exchange Traded Funds are not going to replace Mutual Funds anytime soon.

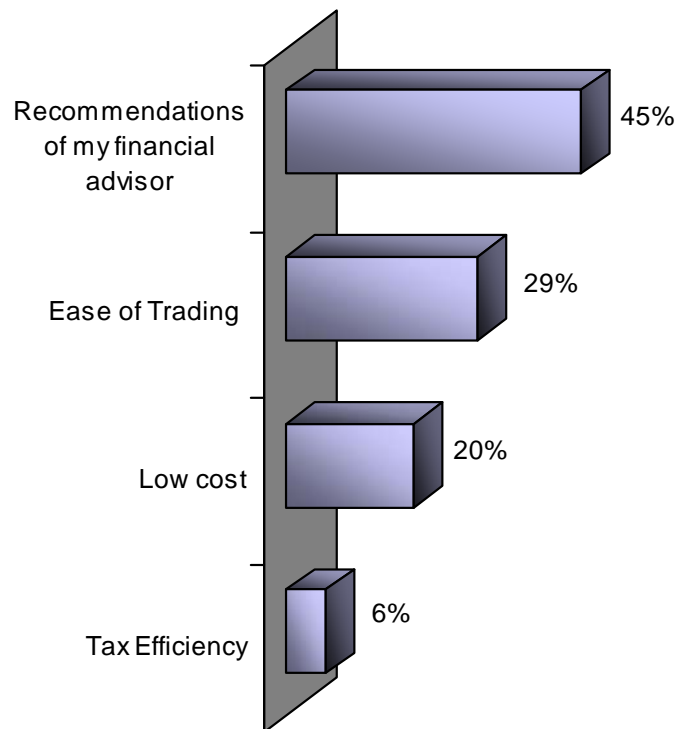
**When You Invested in Exchange Traded Funds,  
Where Did You Take The Money From?**



## Main Reason for Investing in Exchange Traded Funds

Among those with ETF's, nearly half said they invested in them because of the recommendations of their financial advisor. The ease of trading was the next main reason. Low cost was next and the least most important reason cited was for the tax advantages.

**What Is Your Main Reason For Investing in Exchange Traded Funds**



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## Conclusions and Implications

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- **EXCHANGE TRADED FUNDS WILL NOT REPLACE MUTUAL FUNDS** - Mutual Funds have a long track record with Affluent investors. With the advantage of 69 years of marketing, promotion, advertising, and developing a track record, it is little wonder that Mutual Funds are so much more popular than Exchange Traded Funds. Furthermore, Mutual Funds popularity are in large part due to their use in Defined Contributions Plans. Unless Plan Providers and Plan Sponsors see an overwhelming reason to include some type of collective trusts of ETF's within the DC plans, this isn't going to change. Furthermore, in looking at investors who have Exchange Traded Funds, the majority of assets for these funds did not come from existing mutual funds, but from existing cash accounts. Even stocks and other types of accounts were utilized more than mutual funds as a source of money to open an ETF. While ETF's are not going to replace mutual funds, they do have an appeal and a clientele that want the features and advantages ETF's offer.
- **EDUCATE CLIENTS ABOUT ETF'S** – The vast majority of affluent investors who do not have ETF's don't have them because they lack knowledge and understanding of them. Perhaps if they knew more, there would be greater interest in investing. It behooves financial service companies to inform their clients about ETF's, because otherwise, the competition may do so, and given some of the advantages of these products, current clients may move assets to that competitor.
- **NOW MAY BE A GOOD TIME TO INTRODUCE ETF'S TO INVESTORS** - With the troubling market today, advisors and providers may be looking for reasons to reach out and communicate with their clients. Past Spectrem studies indicate that Affluent clients want more contact with their advisors during troubling times. Taking the opportunity to educate and inform clients about Exchange Traded Funds affords providers and advisors another touch point with their clients. Selling points could be the ETF's low cost, tax advantages and ease of trading. To the investor, this indicates their advisor is looking out for their best interest and needs. In today's environment, where there is a shortage of good news, this may pay enormous dividends.
- **IDENTIFY AND TAKE ADVANTAGE OF NICHE WHO WILL USE ETF'S** – Among users, the majority invest in ETF's because their advisor recommended it. It behooves advisors to understand ETF's and then educate their client base who are likely to want to use them. This would include those who are younger and those who have more wealth. In addition advisors should look for those with concerns about tax efficiency, having the ability to easily trade and lowering their costs.